

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

AN ADJUSTMENT OF RATES OF)	
THE MILFORD WATER COMPANY)	CASE NO. 8420
OF MADISON COUNTY, KENTUCKY)	

O R D E R

On December 22, 1981, Milford Water Company ("Milford") filed an application with this Commission requesting authority to increase the rates charged to its customers. The proposed rates would produce additional revenue of \$27,873 annually, an increase of 30 percent above test year operating revenue. Based on the determination herein the revenues of Milford will increase by \$5,125 annually, an increase of 5.5 percent.

On December 29, 1981, the Consumer Protection Division of the Attorney General's Office filed a motion to intervene in this proceeding, which was sustained. A hearing was held in the Commission's offices in Frankfort, Kentucky, on April 15, 1982.

COMMENTARY

Milford is a water company organized and existing under the laws of the Commonwealth of Kentucky, serving approximately 522 customers in Madison County, Kentucky. Milford purchases water from the City of Richmond, Kentucky.

TEST PERIOD

Milford proposed and the Commission has adopted the 12-month period ending September 30, 1981, as the test period for determining the reasonableness of the rates approved herein. Pro forma adjustments found reasonable and proper for rate-making purposes have been included.

VALUATION

Net Investment

The Commission finds from the evidence of record that Milford's net investment rate base at September 30, 1981, is as follows:

Utility Plant in Service	\$ 227,613
Add:	
Materials and Supplies	\$ 156
Working Capital	4,930
Subtotal	\$ 5,086
Deduct:	
Accumulated Depreciation	\$ 35,749
Contributions in Aid of Construction	55,921
Subtotal	91,670
Net Investment	<u>\$ 141,029</u>

Milford proposed a net investment rate base of \$171,692. In determining its net investment rate base Milford used only the utility plant in service less accumulated depreciation as of the end of the test year. In accordance with accepted rate-making practices the Commission finds that the year-end value of utility plant and related facilities less depreciation and contributions in aid of construction, materials and supplies, and working capital is the proper basis for determining the net

investment rate base. The Commission has adjusted the provision for working capital to include one-eighth of out-of-pocket operation and maintenance expenses and exclude any portion of the purchased water costs. The accumulated provision for depreciation also reflects a pro forma adjustment made by the Commission to depreciation expense.

Capital Structure

The Commission finds from the evidence of record that Milford's capital structure at the end of the test period was \$123,194 and consisted of \$87,857 in equity and \$35,337 in long-term debt.

The Commission has given due consideration to these and other elements of value in determining the reasonableness of the rate increase requested herein.

REVENUES AND EXPENSES

Milford proposed no adjustments to the revenues and expenses in its original application. The Commission is of the opinion that the following modifications should be made to the test year expenses:

Purchased Water Expense

Milford's income statement reflected actual test year purchased water expense of \$40,502. Monthly water bills indicate that this amount included a charge by the City of Richmond for the installation of a new meter. The Commission is of the opinion that the cost of the new meter, \$1200, should be capitalized and should not be included in the purchased water expense for rate-making purposes.

Salaries

Milford's income statement reflected an actual test year expense of \$16,020 for the manager's salary. Out of this salary the manager pays the rent, computer charge, utilities, and clerical and meter reader salaries. The Commission has increased this expense by \$490 to cover the manager's pay raise not included in the first 2 months of the test year.

Milford incurred test year expenses of \$7,200 for officers' salaries. Each of the three officers received \$200 per month. In addition, each officer received a director's fee of \$50 per board meeting attended. The record provides no justification for payment of these fees, especially since Milford has a full-time manager. Moreover, since the directors are the principal stockholders of Milford, they are compensated through the return allowed. The Commission is of the opinion that the officers' salaries are excessive and that a more reasonable salary would be \$150 per month per officer, which would reduce this expense by \$1,800.

These adjustments will reduce the actual test year salaries by \$1,310.

Professional Services

Milford incurred \$4,800 of expenses for professional services during the test year. Included in this expense is \$1,200 paid to Mr. Mike Hall, one of the directors. There is no evidence in the record of any duties or services performed by Mr. Hall. Also

included in this expense is \$2,400 in retainer fees to an attorney and an engineer. The Commission is of the opinion that a utility of the relatively small size of Milford should have no reason to have an attorney and an engineer on a retainer. Thus, the Commission has decreased the professional services expense by \$3,600.

Repairs and Maintenance Expenses

Milford incurred repairs and maintenance expenses of \$6,050 during the test year. Mr. Douglas Chenault testified that a majority of the repairs and maintenance expenses incurred in the month of October 1980 was due to damages caused by an earthquake in July 1980. In August 1981, Milford had to relocate its water lines in the Barnes Mill Road area twice for the Department of Highways and was not adequately reimbursed.

Because these two events are unusual and infrequent occurrences, the Commission finds that the test year is not representative of a normal year of operations. The Commission has, therefore used an average of the repairs and maintenance expenses for the 4-year period from 1976 to 1979 to obtain a reasonable level of expense. This analysis results in a projected expense of \$4,998. Because of the extraordinary costs incurred in 1980 this year was omitted from the average.

Depreciation Expense

Milford's income statement reflects depreciation expense of \$4,952 for the test year. This amount of depreciation was based on total plant using a composite rate of approximately

2.2 percent. It is the policy of the Commission to compute depreciation expense for rate-making purposes on the basis of the original cost of plant in service less contributions in aid of construction. The financial statements submitted in the original application reflect that the level of contributions in aid of construction at the end of the test period was \$55,921 which is approximately 25 percent of the total cost of utility plant in service. In determining the pro forma depreciation expense the Commission has utilized Milford's depreciation rates and excluded depreciation associated with contributed property. The adjusted depreciation expense for rate-making purposes is \$3,735.

Miscellaneous Expense

Milford reported miscellaneous expense for the test year of \$679. The Commission has increased this expense by \$8 to reflect the estimated cost of bacteriological analysis based on two tests per month of \$4 per test as shown in paragraph three of Milford's response to the Commission's Order of March 8, 1982.

Milford included a \$35 contribution to the Oleika Temple in miscellaneous expense. The Commission is of the opinion that expenditures of this type produce no benefit to Milford's customers and, therefore, should not be allowed for rate-making purposes. Furthermore, charitable contributions are costs which should be recorded in non-operating expense accounts and should not be included in operating expenses.

The net effect of the aforesaid adjustments will reduce the actual test year miscellaneous expense by \$27.

Rate Case Expenses

Milford incurred total rate case expenses of \$5,149. In accordance with past policy, the Commission has amortized this expense over a 3-year period, resulting in an adjusted amount of \$1,716.

Interest Expense

Milford's income statement reflected test year interest expense on long-term debt of \$4,179. The Commission has decreased this amount by \$952 to reflect annual interest on the long-term debt outstanding at the end of the test year. Both the interest expense on long-term debt and on customer deposits are reflected below the line and should not be shown as operating expenses.

The effect of the Commission's adjustments on the test year operations of Milford is as follows:

	<u>Actual Test Year</u>	<u>Pro Forma Adjustments</u>	<u>Adjusted Test Year</u>
Operating Revenues	\$94,974	\$ 0	\$94,974
Operating Expenses	91,161	(10,917)	80,244
Net Operating Income	<u>\$ 3,813</u>	<u>\$ 10,917</u>	<u>\$14,730</u>

RATE OF RETURN

Milford requested a rate of return on its net investment rate base of 14 percent. This would yield a return on equity of 19 percent. Milford did little to support its requested rate of return other than to point out the interest rates available on

short-term investments at the time the application was filed. The Commission is aware of the rates of return which have been granted in comparable cases. We are also aware of the recent substantial drop in the rate of inflation and the reduction of several points in prime interest rates. Therefore, the Commission is of the opinion that a return on common equity of 14 percent is fair, just and reasonable. A return on equity of 14 percent will yield a return on the net investment rate base established herein of 11 percent.

During the test year Milford achieved a return on net investment rate base of 2.7 percent. After taking into consideration the pro forma adjustments, Milford would realize a rate of return of 7.3 percent. The Commission is of the opinion that this rate of return is inadequate and that a more reasonable rate of return is 11 percent. In order to achieve this Milford should be allowed to increase its annual revenue by \$797. This additional revenue will produce net operating income of approximately \$15,527 which should be sufficient to meet the requirements in Milford's mortgages securing its long-term debt.

In its application Milford, a Subchapter S Corporation, requested an allowance for income taxes because its stockholders pay rates in excess of the lowest rates for corporations. The Commission is of the opinion that the stockholders, who determined to organize Milford as a Subchapter S Corporation under Internal Revenue Code Section 1371, must bear any liability resulting

from this decision. Therefore, in accordance with past policy, the Commission has not included a provision for state or federal income taxes herein.

SUMMARY

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

(1) The rates in Appendix A will produce gross annual operating revenues of approximately \$98,235, including other service income of \$1,864, and are the fair, just and reasonable rates to be charged in that they will allow Milford to pay its operating expenses, service its debt, and provide a reasonable surplus for equity growth.

(2) The rates proposed by Milford would produce revenue in excess of that found reasonable herein and should be denied upon application of KRS 278.030.

IT IS THEREFORE ORDERED that the rates in Appendix A be and they hereby are approved for service rendered by Milford on and after the date of this Order.

IT IS FURTHER ORDERED that the rates proposed by Milford be and they hereby are denied.

IT IS FURTHER ORDERED that within 30 days from the date of this Order Milford shall file with this Commission its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 6th day of July, 1982.

PUBLIC SERVICE COMMISSION

Martin M. Voh
Chairman

Katherine Randall
Vice Chairman

Leo Carver
Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE
COMMISSION IN CASE NO. 8420 DATED July 6, 1982

The following rates are prescribed for water service to the customers of Milford Water Company located in Southeastern portion of Madison County, Kentucky. All other rates and charges not specifically mentioned herein shall remain the same as those in effect prior to the date of this Order.

Rates:

First 2,000 gallons	\$ 7.90 minimum charge
Next 2,000 gallons	2.15 per 1,000 gallons
Next 2,000 gallons	1.65 per 1,000 gallons
All Over 6,000 gallons	1.30 per 1,000 gallons

The minimum bill of \$7.90 shall entitle the user to 2,000 gallons or less per month.